Bear Market Analogues

Past performance does not predict future results, but what else are you going to use? Nations, economies, and industries all rise, fall, and disappear, but human behavior remains constant. This allows technical analysis to work: At its essence, it is nothing more than the study of how people react to a given set of conditions in the market.

Equity and physical commodity markets are quite different in that the underlying asset for equities evolves. For example, 1,000 bushels of soybeans grown today have the same economic role as they did in 1950, while IBM is a very different company. This evolutionary process combined with economic growth and improving technological efficiencies over time allows equities to trend higher for long periods. Physical commodity prices tend to stagnate in nominal dollar terms and decline in real dollar terms with only minor and short-lived exceptions, such as what we see in energy markets today.

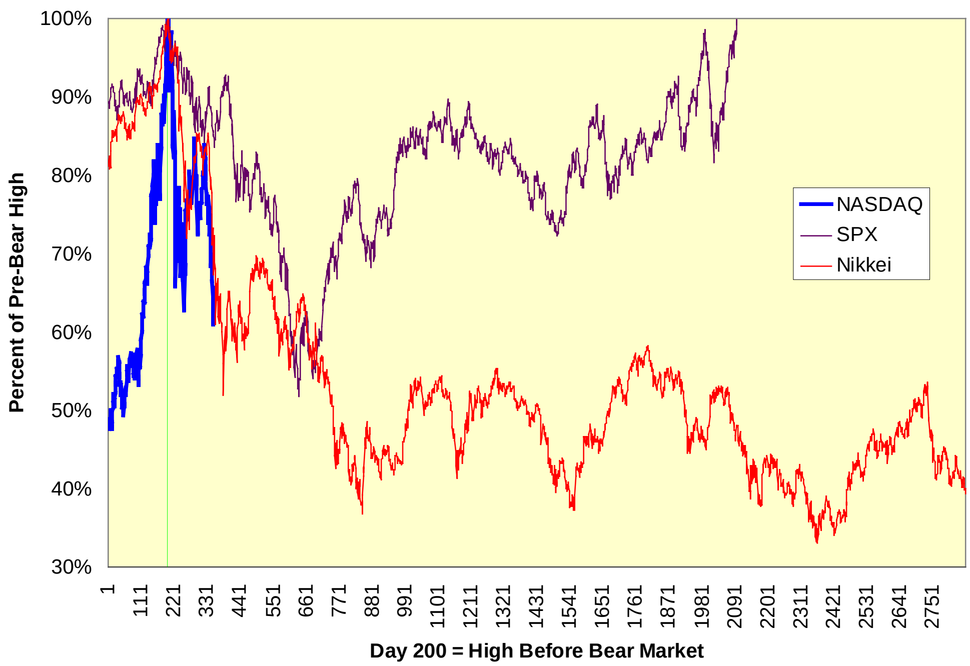
These two factors make bear market analysis (blessedly) difficult: There aren't many of them, they're shorter in duration than bull markets, and people work very hard to destroy them. Still, we can compare the present situation in the NASDAQ to two other bear markets, the ongoing Japanese situation and the 1973-1974 fall in the S&P 500 (SPX).

What Goes Down May Stay There

A bull market is nothing more than a series of new highs interspersed with failed failures, and a bear is just the opposite: A series of new lows followed by failed rallies. We can date the onset of a bear market, therefore, from the last new high and present the data as such. The chart below organizes the data for the SPX, Nikkei 225 (NKY), and NASDAQ Composite as a percentage of their pre-bear market highs. Two hundred days of data before the high are included as a windup period.

The SPX reached a high of 120.24 on January 11, 1973. It did not reach another new high (reinvested dividends are not included in this analysis) until July 17, 1980, nearly 1,900 trading days later. The Nikkei 225 (NKY) reached a new high of 38,915 on December 29, 1989, and has been trading as if won't reach a new high ever again. The index has been under water for close to eleven years, and is trading at less than 40% of its previous high.

Before And After The Fall

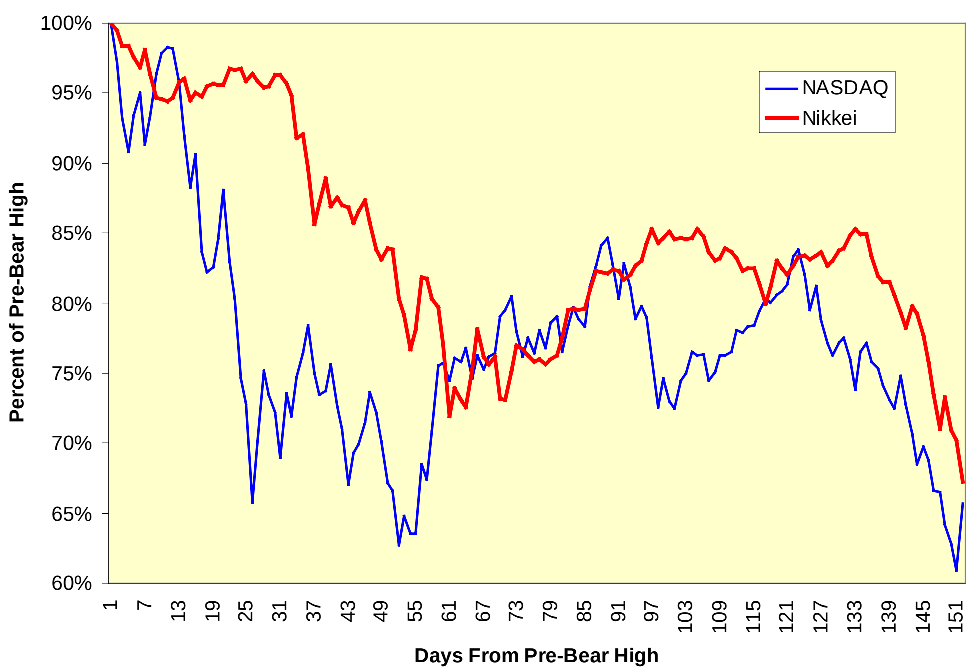


Now we come to our beloved NASDAQ. The Composite hit a new high of 5048.62 on March 10, 2000, and has retraced close to 40% of that value in less than eight months. We can see from the chart above that the NASDAQ's sprint to a record high was far more rapid than the NKY's, which seemed pretty breathtaking at the time. The SPX' climb in 1972-1973 was far more parallel to the NKY's ascent.

Once the SPX began its retreat, it was a far more relaxed downturn than what we can see for either the NASDAQ or the NKY. As late as October 26, 1973, the SPX was only 7.4% below its January high. The break from here, which was accelerated by the first OPEC embargo and surge in crude oil prices, was precipitous. On October 3, 1974, when the SPX hit its intraday low of 62.28, the index closed at only 51.8% of its previous high. As inflationary pressures began to abate under President Ford and his economic advisor Alan Greenspan, the American benchmark rebounded smartly.

The collapses of the NKY and NASDAQ overlap more closely. While it's always a bit dangerous to overlay these curves and claim forecasting ability -- remember, market movements should parallel one another given the constancy of human behavior -- it is still a bit unsettling to compare these two selloffs over a parallel time span, as seen below.

The NKY and NASDAQ: Comparing The Breaks



It could win you a few barroom bets. Not only has the NASDAQ selloff been more abrupt than the NKY's, it moved down further on both its initial break in the spring of 2000 and its secondary break since September 1. To be sure, it has had some strong retracement rallies, but this, too, is part and parcel of normal market rhythm.

Where Do We Go From Here?

The NASDAQ is still expensive by any stretch of the imagination. At the close of business on Friday, October 13, 2000, the index had a trailing P/E of 115.63, which is an E/P of 0.8648%. With a Ten-year Treasury note yielding 5.721%, this gap between stocks and would require NASDAQ earnings to outpace Treasury yields by 6.335% per annum for the next ten years. Is this possible? It certainly is, but it's a poor risk/reward bet: A comparable earnings growth margin for the SPX is 3.048%.

It's tough to remember just how efficient Japan looked during the 1970s and 1980s, and how so many thought their business-as-war culture and alleged long-term outlook were to be admired. As a result, many bought Japan after the fall, and are still waiting to get their money back. Will this be the case for the NASDAQ and its highly admired technology sector? We cannot know in advance, but let's hope not.